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The Bear is doing his nasty job. What's his job? It's to move the stock market down while keeping as many people as possible in the market. How does he do it? Periodic rallies, rallies that convince people that "all is well." Rallies that keep people wondering, if "we are really in a bear market." Plus, of course, the usual bullish blather from media and Wall Street "experts" who haven't a clue as to what's really happening.

— Richard Russell, *Dow Theory Letters*, Sept. 9, 1998

AN INEVITABLE RECESSION AND BEAR MARKET

Apparently, the sudden sell-off in equities, commodities and some currencies has caught the great majority of investors by surprise and therefore on the wrong foot. Is this just one of those temporary corrections that occasionally interrupts bull markets, or is it the beginning of a long, perhaps even secular, bear market?

Total losses in stock markets are estimated at $2 trillion. Those assets that had risen most during recent months have fallen most. Between May 10–June 15, the S&P fell 6.5%, while emerging markets fell 20%. But it was not just markets with thin trading and poor liquidity that suffered significant losses. Particular attention focused on countries such as India (down 24%) because of its spectacular market advance over the past two years and its highly praised economic boom.

Tokyo's Nikkei lost 15%. Japan's economy, too, had enjoyed positive attention owing to the perception that it may be shaking 15 years of stagnation. Notably, most of the rise in Japan's stock market (54% within the past 52 weeks) has been driven by foreign money, not domestic investment. Japan was part of the hectic global search for higher returns.

A study of U.S. mutual fund flows tells the story of money chasing returns and then suddenly retreating. In 2005, U.S. investors deposited $147 billion in equity mutual funds, of which $86 billion went into international assets. The chase for rising markets accelerated in the first quarter of 2006, with net stock fund inflows of $83 billion (annualized $332 billion), and that in a country with negative personal savings. Over $52 billion went into international funds and $13 billion into emerging markets.

The pursuit of rising markets continued to intensify. In the week ending May 10, the day the Dow and the S&P started their recent slide, $2.5 billion of $2.9 billion net U.S. equity fund investment — a full 86% — went into international funds.

Most remarkable and most intriguing were the losses in commodities and precious metals. During the mid-May–mid-June drop, copper lost 28%, aluminum 21%, lead 27%, nickel 22% and zinc also 22%. Gold lost 17% and silver 28%.

These big losses in commodities and precious metals manifestly put the lie to the view that the markets were shaken by an inflation scare triggered by recently higher U.S. inflation rates. They are, though, consistent with the observation that what rose fastest also fell fastest. The oddest thing, surely, has been the steep fall of gold and precious metals.

Right from the beginning, it has been our suspicion that the precious metals were temporarily sucked into the highly leveraged commodity speculation, in which retail participation is minimal.

The big difference between gold investment and gold speculation may be exemplified by a comparison with the popular gold exchange-traded fund (GLD). It holds $7 billion in assets and is a practical way for individuals

to get exposure to the gold market. Yet in the recent past, it has only received a fraction of the interest that went into emerging markets. In other words, gold investment by individuals and their selling was not involved.

One apparently reasonable explanation for the sudden market shock is that the Bank of Japan is withdrawing its abundant monetary support of global yen carry trade. The first wobble in the markets occurred, in fact, just after Tokyo announced a change in its "quantitative easing." As we shall show later in this letter, dramatic changes have occurred in Japan's monetary base. But there is zero sign of any tightening in short-term interest rates.

THE ANSWER LIES IN THE U.S. ECONOMY

This brings us back to the top question of whether we have witnessed a temporary correction to be followed by a continuing bull run of stocks and commodities, or whether this has been the start of a vicious secular bear market.

In our view, the final answer to this question does not lie in the markets. It lies in the global economy, or, more precisely, in the U.S. economy. That is, in the question of whether or not the U.S. bubble economy is in exhaustion.

We, too, can only guess what has so badly pricked so many markets, but we know one thing for sure: that a drastic slowdown of the U.S. economy will definitely turn these "corrections" in the markets into the beginning of a secular bear market.

Today, there prevails a general conviction that the world economy, led by the U.S. economy, is in the midst of a global synchronized economic expansion. We vigorously disagree. As we verify later in the letter, this is a grossly distorted picture based on grossly distorted numbers.

But there is a second point of our radical disagreement with the optimistic consensus, and it concerns the efficiency of monetary policy. Under American influence, a conviction has developed that monetary policy is almighty under any circumstances. Central banks simply open their money and credit spigots, and everything runs as desired.

In line with this thinking, since 1999, the Bank of Japan (BOJ) has slashed its interest rate to zero and flooded its banking system with reserves in the face of shrinking private credit demand. For many years, this has had zero response in the economy. The main effect was in stimulating global speculation through the virtually limitless availability of yen carry trade.

The common explanation is a sudden risk-awareness of investors. That seems self-evident, but only leads back to the question of its underlying cause. In our view, just one single explanation makes sense overall, and that is anxiety about further rate hikes to curb inflation while the economy is sharply slowing. This is the scare, not inflation as such. It is, in fact, the worst policy dilemma a central bank can face.

At the same time, we are permanently on the lookout for changes in liquidity — to be precise, for changes in the availability of cheap credit for economic activity and speculation. The general perception holds that global markets are flooded with excess liquidity desperately chasing rising asset prices for quick profits. Though this is true, it needs some caveats.

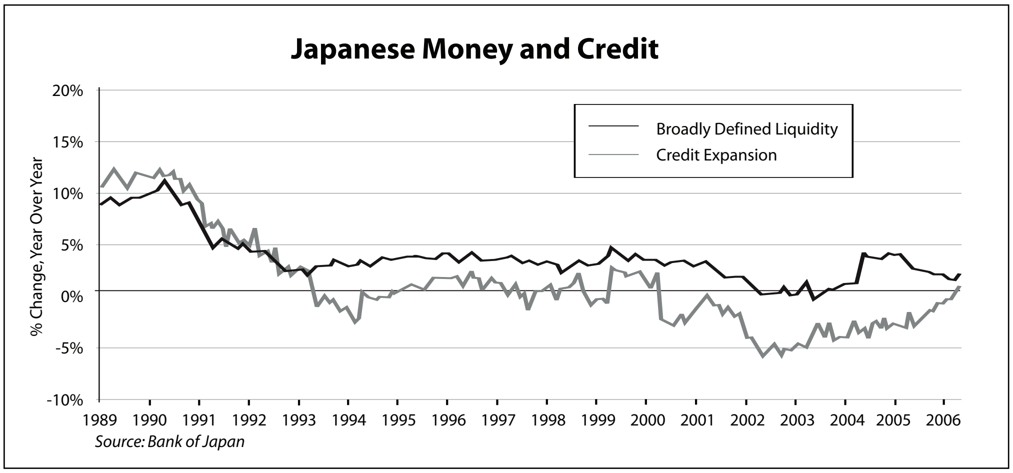
THE TWO BUBBLE BLOWERS

The fact is that this global speculative mania has been abundantly fostered by two central banks. One is the U.S. Federal Reserve Bank, by implementing its rock-bottom rate of 1%, and the other is the Bank of Japan with its "zero interest rate policy."

Every central bank has two levers to stimulate credit demand in the economy. One is lowering interest rates. The other is pumping liquidity into the banking system. Both central banks have used their levers. In the United States, this has worked, though very much less so than in the past. What emerged despite monetary and fiscal stimulus of

unprecedented dosage was the weakest and also the most lopsided economic recovery in the postwar period.

In Japan, much more drastic monetary ease has not worked at all. After a second severe recession in 1998, following years of near stagnation, the BOJ shifted to a "zero interest rate policy" in February 1999. In addition, it publicly announced it would provide "*ample reserves in excess of requirements.*" Though this established unprecedented monetary looseness, it had zero response in the economy for many more years.



Actually, the drastic monetary easing had very disappointing effects in both countries, though much more so in Japan than in the United States. The difference, really, is that Japan had to cope with two bursting bubbles, equities and commercial real estate, while the United States had the bursting equity bubble and the nascent housing bubble.

The second highly important difference between the two countries is in the fact that the monetary easing in the United States had sweeping effects on stock and house prices, which strongly boosted consumer spending. In Japan, the far more drastic monetary easing even failed to stop the savage deflation in commercial real estate prices.

The aggressive liquidity injections in connection with the "zero interest rate policy" were briefly interrupted in 2000. In March 2001, the BOJ announced the introduction of a new "quantitative monetary easing policy." This consisted of flooding the banking system with even more prodigious liquidity injections, including the commitment to continue these "*until the rate of change of the core rate of inflation becomes zero or positive on a sustainable basis.*"

By the first quarter of 2004, the Bank of Japan had created liquid bank reserves in the amount of 35 trillion yen, compared with actually required reserves of 6 trillion yen. At the time, this was equivalent to $360 billion.

In 2000, the Bank of Japan started its great buying binge of dollars with the twofold purpose to prevent or curb a rise of the yen and to flood its banking system with liquidity. At the time, its total foreign reserve holdings amounted to $360 billion. So far, they have been reduced to $11 billion, remaining thus in excess of requirements. Meanwhile, Japan has been overtaken by China, which started with foreign reserve holdings of $165 billion in 2000. Together, the two central banks more than financed the U.S. tax cuts. In essence, they acted as Mr. Bernanke's helicopters, dropping around a trillion dollars, acting as bank liquidity, into the U.S. economy over these years.

But the difference in economic effects between the two countries could not have been more dramatic. China's economy is booming even faster than Japan's economy in the late 1980s. In the case of Japan, one can only hope that the current modest recovery will prove sustainable.

So have these two central banks with their huge dollar purchases been crucial in supporting U.S. economic growth? To be precise, they have been crucial in extending the U.S. bubble economy with all its domestic excesses in spending, debt creation and structural distortions. It is an economy in which debt creation and income creation on the part of the consumer have run absurdly out of line, and it is worsening.

In the first quarter of 2006, debt increased by 11.6%, annualized, compared with zero growth in real disposable income. The one thing that still separates the U.S. economy from economic and financial disaster is

disposable income. The one thing that still separates the U.S. economy from economic and financial disaster is rising house prices that apparently justify ever more credit and debt.

As to China, we have the impression that its rulers are eager to repeat Japan's folly to create an unsustainable investment bubble, only at a much grander scale, in relation to the economy's size.

It makes headlines that Japan may end its "quantitative easing" in a few months. It never made sense in our view. Where there are no borrowers, no amount of liquidity injection will increase the money supply and reflate the economy. It cogently indicates that there must be other reasons than just interest rates to prevent investment. Actually, we can imagine quite a few other reasons.

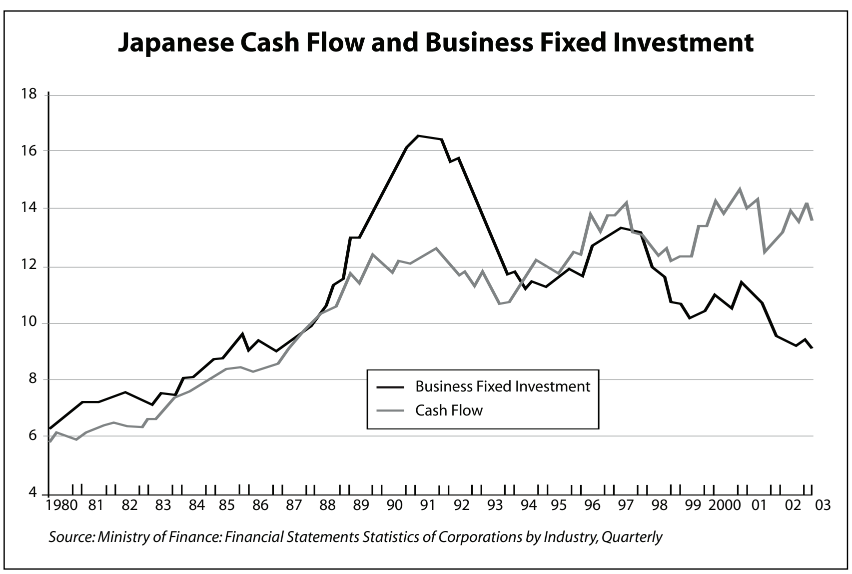
MONETARY EASING FAILS

The folly is in the categorical assumption of American monetarists that sufficient monetary ease can never fail to stimulate sustainable economic growth. With this assumption in mind, they have rewritten the history of America's Great Depression of the 1930s. Until long after World War II, it was the accepted notion that this Depression had its decisive causes in a variety of severe structural damages, which the U.S. economy and its financial system had incurred in the prior boom years.

American monetarists' lack of thinking starts with the absurd assumption that whatever happens during the boom is irrelevant. The one and only thing that matters is swift easing when the economy weakens, essentially implying that proper monetary easing solves any possible problem.

It is an absurd view. In Japan's case, it could not be more obvious what is ailing the economy. It is a structural disease ailing many developed industrial countries today, among them Germany and France. It is, in short, insufficient investment in relation to saving. A boom is generated when investment exceeds saving, and a slump is generated when saving exceeds investment. The latter was the key cause of the Great Depression in the 1930s.

The chart below shows Japan's intricate structural problem at a glance.



During the boom years in the 1980s, corporate businesses borrowed in excess of their current cash flow to the tune of 10% of GDP. Since 1994, after radically slashing their investment spending, they regularly repay debts to the tune of about 4% of GDP annually. Compared with the boom years, this means an annual spending loss of nearly 14% of GDP.

A decline in personal savings and permanent large budget deficits of the government have cushioned this savage demand contraction on the part of the business sector to a considerable extent. Yet there remains a demand gap keeping real GDP growth depressed. For many years now, the zero interest rate policy has piteously failed to stimulate both consumer spending and investment spending.

Nobody in Japan expects the consumer to close the existing demand gap with higher borrowing. It conflicts with the national and the family tradition. The question to ask, essentially, is why businesses give preference to repaying debts even at near-zero interest rates.

Knowledgeable people in Japan say this is because the boom has left firms with excess capacities, excess debt and collapsed asset values. Commercial real estate prices, playing a big role in Japanese balance sheets, are down 85% on average. Stock prices still have lost more than 60% from their peak. Instead, corporations heavily invest in low-wage Asia, and for sure, general growth expectations have also been slashed.

Therefore, many years of the most aggressive monetary ease have flatly failed to revive business investment and economic growth. For some observers, this was predictable. But we have other strong objections to this Japanese monetary folly. Instead of stimulating business investment in Japan, it has fostered and funded the world's greatest speculative bubble in history by making ultra-cheap yen carry trade available.

According to the Bank for International Settlements (BIS), borrowing in Japanese yen at zero percent over the seven quarters to the end of 2005 has surged by $161 billion, with three quarters of this lending flowing to international financial centers such as the United Kingdom, Singapore and the Cayman Islands. From there, the funds are promptly re-lent to the capital-hungry Anglo-Saxon deficit countries, spending increasingly in excess of their domestic production.

THE ANGLO-SAXON SOLUTION

The Anglo-Saxon countries have been the high-growth economies among the industrialized economies. By definition, strong economic growth implies that domestic investment exceeds domestic saving. Actually, Mr. Bernanke and others have repeatedly justified the capital inflows with the fact that capital investment exceeds domestic saving.

On the surface, this is true. But this description represents a grotesque distortion of the economic reality. What has truly happened in the United States and the other English-speaking countries is that private households, in response to inflating house prices, have slashed their savings even faster than businesses slashed their capital investments. As a result, minimal investment exceeds nonexistent domestic saving. This explains their stronger economic growth.

To illustrate this with a comparison: In France, the personal saving rate is hovering lately at around 11.4% of disposable income, literally the same level as in 2000. This stability in savings has prevailed despite sharp rises in house prices because everybody in France regards this as inflation, not as saving. Living systematically beyond one's means is not a way of life in France and many other countries.

In the United States, personal saving over the same period has slumped from 2.3% of disposable income to –1.6%. The key point to see is that the stronger growth of the Anglo-Saxon countries had one single overriding reason, and that was to boost consumption at the expense of savings. If the United States had the savings rate of most European countries, it would be in depression.

A CREDIT MACHINE RUNNING AMOK

Now to the U.S. economy. With zero savings and runaway credit expansion, the United States ought to have sky-high interest rates. Thanks to large bond purchases by the Asian central banks and the virtually limitless availability of carry trade in dollars and yen, implemented by the two central banks, U.S. long-term interest rates have held at absurdly low levels. On the surface, interest rates are determined in the markets. In these two countries, they are heavily manipulated by the central banks.

Strikingly, the Fed's 16 rate hikes over the last two years have done nothing to curb the recorded domestic credit expansion. Yet dollar carry trade, which also has played an important role in funding highly leveraged asset purchases, is dead in the water, simply because short-term rates have caught up with long-term rates. Astonishingly, the bond market has only minimally reacted.

Barely noticed, the U.S. credit machine ran amok again in the first quarter of 2006, revealing the Fed's

tightening as a farce. Nonfinancial credit expanded $2,914.0 billion, annualized, up from the prior quarter's $2,434 billion. Together with an increase in financial credit by $1,479.2 billion, the total adds up to $4,392.8 billion.

Compared with an increase by $827 billion in 2000, credit and debt growth has quadrupled. Total outstanding indebtedness rose to $41.8 trillion, equal to 334% of nominal GDP and 376% of real GDP. In the first quarter, $4.30 of additional debt was added for each dollar added to nominal GDP growth and $7.50 additional debt for each dollar added to real GDP growth. Until the late 1970s, this credit-to-GDP ratio had held at a steady rate of 1:1.4 for over 30 years.

In a country without domestic savings, the money for such a runaway credit expansion must implicitly come from credit creation through the domestic financial system and foreign investors and lenders.

Strikingly, in the first quarter, U.S. commercial banks boosted their "net acquisition of financial assets" by a blistering $957 billion, annualized, as against $791.1 billion in 2005 and $472.4 billion in 2000. Net acquisitions of security brokers and dealers surged at an annual rate of 28%, to a record $611 billion. Foreign net acquisitions of financial assets in the United States rocketed to $1.492 billion, against $889 billion in the prior quarter.

Sorry for all the figures, but knowing them is of greatest importance. They contain the solution for the famous "conundrum" of stable U.S. long-term interest rates defying all the rate hikes. There were rate hikes, yes, but measured by the pace of the credit expansion, there has not been the slightest monetary tightening. Instead, the Fed has accommodated runaway and permanently accelerating credit growth.

Nevertheless, as explained, the rate hikes at the short end of the yield curve have cut off the dollar carry trade. But it has been replaced through sharply accelerating U.S. domestic bank credit expansion, and further highly leveraged carry trade in yen, but perhaps also in euro and the Swiss franc and bond purchases by Asian central banks.

Of course, rate hikes are generally applied to put a brake on credit growth and price inflation. The fact that in the United States the credit expansion sharply accelerated exposes the rate hikes as an outright sham. The point is that the Fed kept the banking system liquid enough to continue an aggressive credit expansion.

In the case of private households, the lure of higher house prices has plainly more than offset any restraint from higher interest rates, what a central bank ought to take into account. We doubt that they ever wanted true significant restraint in borrowing and spending, because they are afraid of it happening. They want lower inflation, but not lower spending.

Household debt expanded in the first quarter of 2006 to $1,333.9 billion, annualized, a new record. Business debt soared by $864.3 billion, up from $611 billion in 2005. Financial credit jumped by $1,479.2 billion, against $1,036.7 billion in 2005. Any talk of credit restraint is absurd.

BUBBLE-DRIVEN, NOT ASSET-DRIVEN

Yet the most important credit source for economic activity during the past few years is running out of steam, not because monetary conditions have become tight, but because the delivery of collateral for higher borrowing against rising house prices has slowed sharply in line with their sharp slowing. Popular year-over-year comparisons, by the way, are deceptive. What matters are the recent changes.

Purchasing power currently spent comes from income or credit. In times of yore until 2000, U.S. private households got their purchasing power, like everywhere else in the world, overwhelmingly from current income, provided by increases in employment and real wages. During 1995–2000, overall real disposable incomes rose over 4% per year on average.

Yet since the early 1980s, there has been a steadily growing resort by households to borrowing, as reflected in a steadily falling savings rate. After 10% of disposable income at that time, it was down to only 2.3% in 2000.

From then on, the relationship between income growth and debt growth has radically reversed. Debt growth has escalated ever faster in comparison to income growth. Real disposable income growth, even though heavily bolstered through tax cuts, averaged only 2.7% until 2004. In 2005, absent new tax cuts, it grew a mere 1.3%. Over the first four months of 2006, it has been zero.

This recovery of the U.S. economy since November 2001 has been dominated by an unprecedented consumer borrowing-and-spending binge. In the first quarter of 2006, consumer debts had risen 70% from 2000, against an increase of real disposable incomes by 12%.

American policymakers and economists find it convenient to speak of "asset-driven" economic growth, in contrast to the "income-driven" growth pattern of the past. First of all, we object to this juxtaposition. "Asset-driven" is a euphemism for "bubble-driven," because what matters is not the existence or creation of assets, but their soaring prices celebrated as "wealth creation." The second utterly negative point to see is that this asset price inflation has been manifestly driven by ultra-cheap and loose money and credit, and not by saving and investment.

Since 2001, surging house prices providing ballooning collateral for consumer borrowing plus massive fiscal stimulus have been instrumental in offsetting the contractive effects of the bursting equity bubble and in generating the following recovery, but a recovery of gross failings.

With short-term rates now up to 5% and the housing bubble slowing down, the possibilities of borrowing are bound to shrink. To nevertheless maintain further increases in consumer spending, much stronger income growth will be needed either through higher real wage rates or higher employment.

BAD EMPLOYMENT NEWS

What are the chances? In brief, employment and income growth are worsening. First of all, wage growth is barely matching the rise of the inflation rate. So everything depends on stronger employment growth.

This, however, dramatically deteriorated in April and May. Instead of an expected 400,000 new jobs over the two months, the reported gain was a miserable 208,000, even though the Bureau of Labor Statistics (BLS) fabricated record phantom job growth through its dubious "net birth/death" model — 271,000 for April and 211,000 for May. Yet even including these 482,000 phantom jobs, the reported figures are flatly awful, implying further income stagnation, if not worse.

With these numbers, the BLS is apparently making the ridiculous assumption that employment growth among new small firms outside its survey must be booming, while sharply falling in the economy as a whole, captured by its survey. It is always amazing how readily the consensus accepts such manifest nonsense. Wishful thinking prevails over serious analysis.

Looking at the monetary aggregates, something else strikes us as most ominous, and that is the difference between record-strong double-digit credit and debt growth and record-low growth of the money supply. M1 and M2 gained 3.2% and 4.9% over the last quarters. Adjusted for CPI inflation, this was close to zero for M1 and up just 1.3% for M2. We regard this as ominous because credit stands for debt, while money supply stands for liquidity.

Recently, we made an inquiry among American friends, posing to them the question whether there is any thought or talk in public of a possible recession in the United States. It occasionally pops up in the press, we learned. But the consensus opinion, in particular on Wall Street, flatly discards it as a possibility. It was precisely the answer we had expected.

It is a historical fact that American policymakers and conventional economists have never foreseen a recession. In 2000, the Fed hiked its rate twice during the first half, just before the economy began its slump. Equities already had started to crash in March. Reading several reports with forecasts published in late 2000, among them the OECD *Economic Outlook*, we found nowhere the slightest hint of a coming recession.

There seems to be a general conviction, cultivated not just by Mr. Greenspan, that the U.S. economy has

become virtually immune to recession. It is widely seen as just a bursting of strength due to ingrained "flexibility" and "dynamism." In addition, there is, of course, unbounded faith in the virtuosity of the Fed to avoid a serious recession with swift action.

BY FAR THE WEAKEST RECOVERY

Trying to assess the situation and further growth prospects of the U.S. economy, the first important fact to see is that the U.S. economic recovery since November 2001 has been by far the weakest in the whole postwar period. Just a few tidings composed by the Economic Policy Institute in Washington:

First, inflation-adjusted hourly and weekly wages today are below where they were at the start of the recovery in November 2001; *second*, median household income (inflation adjusted) has fallen five years in a row and was 4% lower in 2004 than in 1999; *third*, total jobs since March 2001 (the start of the recession) are up 1.9% and private jobs 1.5% (at this stage of previous business cycles, jobs had grown 8.8%); *fourth*, the unemployment rate is low only because several million people have given up to look for a job.

And here are some cursory remarks on our part: *First*, job growth has steeply fallen during the last three months, from 200,000 in February to 75,000 in May; *second*, all the job growth has come from the artificial net birth/death model, implying that it is booming among small new firms not captured by the payroll survey, while slumping in existing firms; *third*, private household indebtedness since 2000 has soared by 70%. This compares with an overall increase in real disposable personal income by 12%.

CONSUMER SPENDING BREAKING DOWN

According to the popular GDP accounts, consumer spending in the first quarter has burst by a record rate of 5.2%. That is the fact on which everybody happily focuses. Few people realize, first of all, that this is an annualized figure. The true increase against the prior quarter was 1.3%.

In any case, though, it is a grossly distorted figure. The ugly reality of the first five months of 2006 is that the consumer-spending boom of the past few years has effectively broken down. But to realize this, it is necessary to look at the sequence of monthly data. Here they are, from the same source as the GDP numbers, the Bureau of Economic Analysis (BEA):

Personal Income and Outlays
(Percent change from the preceding month in chained dollars)

	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Personal Income	0.4	0.7	0.5	-0.2	0.2	0.0	-0.1
Expenditures	0.1	0.9	0.7	0.3	0.2	0.1	0.1

By these figures, measuring spending and income growth from month to month, consumer spending in the first quarter has increased 0.6%, or 2.4% annualized, less than half the 5.2% as reported in the GDP accounts. As we have stressed several times before, the big difference between the figures arises from the fact that the GDP measures changes in averages. The big increase in consumer spending happened in reality in November/December 2005, resulting in a large "overhang" for the following quarter.

To detect a recent change in trend, it is necessary to focus on the changes from month to month, as above. For May, reported retail figures showed an increase by 0.1% before inflation. With a monthly inflation rate of 0.3%, total real spending should be at a minus.

This sudden weakness in consumer spending has an obvious reason. The spending bubble on consumer durables — that is, on autos and housing durables — is going bust. It was largely spending borrowed from the future to be implicitly followed by payback time.

For us, this rapid, steep decline in the growth of consumer spending is the first decisive consideration to

expect in the United States' impending serious recession; and remarkably, this is happening with record credit growth and even before the housing bubble is truly bursting.

That this most important fact goes completely unnoticed says something about the depth of research. Moreover, this sharp slowdown in consumer spending strikingly conforms to the downward shift in the growth of real disposable personal incomes. In 2005, it was already down to 1.3%. So far in 2006, it is zero.

Under these miserable income conditions, the strength of future consumer spending manifestly depends on the possibilities of ever-higher cash-out mortgage refinancing against rising house prices. It hardly requires any intelligence to have realized by now that this is flatly impossible.

Looking at the accelerating credit expansion, we are, as a matter of fact, more than doubtful that the slowdown in the economy and the housing bubble has anything to do with the Fed's rate hikes. What crucially matters for both is the current credit expansion, and that keeps accelerating. But the problem is that more and more credit creates less and less economic activity, as measured by GDP.

A CREDIT MOLOCH

The unrecognized problem in the United States is that economic growth driven by a housing bubble is extremely credit and debt intensive. It needs, *firstly*, heavy borrowing to drive up the house prices and, *secondly*, further heavy borrowing to turn the resulting capital gains into cash. Put this together with minimal or now zero real disposable income growth and you have something like a credit Moloch devouring credit and leaving less and less for economic growth.

Yet we are sure that the U.S. economy's extraordinary debt addiction has other reasons unrelated to the housing bubble. One is the huge trade deficit, and the other is extensive and rapidly increasing Ponzi finance.

The American consensus view holds that the trade deficit, however large, does not matter because foreigners easily finance it. This view reveals the total absence of any serious analysis of related domestic income and debt effects. The obvious first major harmful economic effect is that domestic producers lose an equal amount of domestic spending and income creation to foreign producers, and that today in a staggering annual amount of more than $800 billion, equal to about 7% of nominal GDP.

Such persistently large and growing income losses from the trade deficit would have pulled the U.S. economy into recession long ago. It has not happened because the Greenspan Fed, by way of loose and cheap money, provided for a compensating increase in domestic demand through additional credit creation. It succeeded, true, but the thing to see is the additional credit and debt creation. This was justified with low inflation rates. Ironically, the import boom in the trade deficit has been very helpful in suppressing U.S. inflation.

Yet there is still a second major harmful effect to the trade deficit that American economists completely ignore. Implicitly, the alternative demand created by the looser U.S. monetary policy is different from the demand that emigrates to foreign producers. The big loser is the export industries in manufacturing. The gains, via the surrogate demand, have been in consumer services and goods.

In essence, the trade deficit alters the economy's structure in a negative way. The losing manufacturing area is the sector with the highest rate of capital formation, and therefore also the highest rate of productivity growth. For good reasons, it also pays the highest wages. Consider that U.S. manufacturing lost 3 million jobs in the past few years. To be sure, the trade deficit is not its only reason, but unquestionably a major one.

BOOMING PONZI FINANCE

Pondering the U.S. economy's unusually high addiction to credit and debt growth in relation to GDP growth, we are sure of another evil factor — Ponzi finance. Principally, every increase in spending brings about an equivalent increase in incomes. But this is not true in three cases of spending: *first*, spending on existing

assets; *second*, spending on imports; and *third*, Ponzi finance.

Ponzi finance means that lenders simply capitalize unpaid interest rates. Ponzi finance creates credit, but it is bare of any demand and spending effects in the economy. In the conventional American view, balance sheets of private households are in their very best shape because increases in asset values have vastly outpaced the sharp increases in debts. So Americans see no problem.

With such great optimism about the U.S. economy still prevailing, it is a safe assumption that lenders have been more than happy to capitalize unpaid interest rates as new loans, at least until recently. As widely reported, lending standards have been extremely lax for years. Nevertheless, there is bound to come a point where Ponzi lending stops.

The crucial difference is in the ghastly difference between runaway debt growth and nonexistant real disposable income growth as the income component from which debt service has to be paid. In 2000, consumer debt growth of 8.6% compared with real disposable income growth of 4.8%. During the first quarter of 2006, private household debt growth of 11.6%, annualized, compared with zero real disposable income growth.

These numbers suggest that, in the aggregate, all debt service occurs through Ponzi finance. Essentially, borrowing against existing assets is required to service debt. Another striking evidence of extensive Ponzi finance is the unusually large difference between rampant credit growth and much slower money growth. Capitalizing unpaid interest rates adds to outstanding credit and debt while adding nothing to bank deposits (money supply).

To get an idea of the actual extent of Ponzi finance, we make a simple calculation. Total outstanding debts in the United States amount to $41.8 trillion. Assuming an average interest rate of 5%, this implies an annual debt service of about $2 trillion. This compares with an increase in national income before taxes of $616 billion in 2005. Consumer incomes are even stagnant.

WHAT KIND OF LANDING?

Under these conditions, the only question is the severity of the impending U.S. recession. In this respect, we are a great believer in the axiom of Austrian theory that every crisis is broadly proportionate to the size of the excesses and imbalances that have accumulated during the prior boom. Our basic assumption is that the American consumer is bankrupt when house prices fall 20–30%.

The most important thing to realize is that the spending and debt excesses that have accumulated in the U.S. economy and its financial system on the part of the consumer during the past 10 years are altogether of a size that vastly exceeds the potential for debt service from current income.

With stagnant real disposable income and double-digit debt growth, the American consumer is caught in a vicious debt trap. What, then, makes most people so optimistic of further economic growth? Apparently, there is a widespread view that households have sufficient equity cushions in their balance sheets to not only weather any storm ahead, but also to continue higher spending.

In our view, the most important thing to see is the fact that the consumer has accumulated debts at a level vastly exceeding his abilities of debt service from current income. Probably many never had any intention of such kind of debt service. The general idea, certainly, has been to settle debt and debt service problems simply by selling later to the highly appreciated greater fool. That is what most economists take for granted.

What all these people overlook is, first of all, the vicious dynamics of Ponzi finance through compound interest on unproductive indebtedness. During 2000, total financial and nonfinancial credit and debt growth amounted to $1,605.6 billion. In 2005, it had accelerated to $3,335.9 billion; and in the first quarter of 2006, it has run at an annual rate of $4,392.8 billion, and this now with zero income growth. Note that this debt explosion has happened with little change in GDP growth.

Given this precarious income situation on the one hand and the debt explosion on the other, it should be clear that at some point in the foreseeable future, there will be heavy selling of houses, with prices crashing for lack of buyers.

As to the level of asset prices in the United States, an additional comment is probably needed. Normally, the money for asset purchases comes from the savings out of current income. In the U.S. economy, with savings in negative territory, all asset purchases essentially depend on available domestic credit and capital inflows. Buying assets on credit used to be the exception. In America today, it is the rule. For good reasons, the Fed is fearful to make money truly tight; it would crush the markets.

A study by the International Monetary Fund published in 2003 under the title "When Bubbles Burst" examined the differences in economic effects between bursting equity bubbles and bursting housing bubbles. It left no doubt that the latter are the far more dangerous specimen:

> *Housing price crashes differ from equity price busts also in three other important dimensions. First, the price corrections during house price busts averaged 30%, reflecting the lower volatility of housing prices and the lower liquidity in housing markets. Second, housing price crashes lasted about four years, about 1 1/2 years longer than equity price busts. Third, the association between booms and busts was stronger for housing than for equity prices.*

The situation today in the United States reminds us strongly of late December 2000. At its previous meeting in November, the Federal Open Market Committee directive had called future inflation the economy's greatest risk. But then, all of a sudden, the bottom fell out of the economy. At its next meeting, on Dec. 19, the FOMC changed the bias, declaring that the risk of economic weakness was outweighing the risk of inflation.

Two weeks later, Jan. 3, 2001, shocked by worsening economic news, the Fed dropped its funds rate, through a conference call, by 0.5% — twice the usual rate.

As we have stressed many times, the U.S. economy today is incomparably more vulnerable than in 2000. All the growth-impairing imbalances in the economy — the trade deficit, the savings and incomes shortage and the debt levels — have dramatically worsened.

Very rapid interest rate cuts and prompt massive government deficit spending succeeded in containing the recession. The phony "wealth effects" derived from the escalating housing bubble became the key source of demand creation in the United States. But the unpleasant longer-term result of the new policies was an unusually weak and lopsided economic recovery, particularly seeing drastic shortfalls in employment and income growth.

BUSINESS INVESTMENT — THE GREAT LAGGARD

The one thing that could possibly prevent the impending consumption-driven recession in the United States would be a strong recovery in business fixed investment. Actually, U.S. corporations have heavily borrowed during the past few years, which used to indicate strong investment spending. This time, however, such borrowing mainly reflects extensive corporate stock buybacks and mergers and acquisitions, rather than investment in new productive plant. The important point is that these kinds of corporate borrowing and spending add nothing to GDP growth and income creation.

It was the abruptly steep decline of business fixed investment that drove the U.S. economy into recession in 2001. Ominously, the following investment recovery has proved eminently weak. Between 2000–05, consumer spending accounted for 85% of real GDP growth and residential building for 11.8%. Together, the two add up to 96.8%. The allocation from business fixed investment was 4.3% and government spending 20%. The cumulative trade deficit amounted to $2,626.2 billion. This compares with a formerly traditional growth pattern as follows: consumption 60%, business fixed investment 20%, government sector 20%.

The obvious calamity is the exorbitantly high share of consumption against the unusually low share of business fixed investment. Even that is a dubious figure, as it overwhelmingly reflects the hedonic pricing of computers, translating quality improvements, translating into price reductions, and thereby into increases in real terms.

As the Bureau of Economic Analysis suppresses the publication of the absolute numbers, it is difficult to weigh this statistical contribution. But from old issues of the *Survey of Current Business* containing these numbers for past years, we have made a stunning calculation: The amount actually spent on computers in current dollars in the first quarter of 2006 was $109.3 billion, annualized. That was precisely the same amount as in 2000. In other words, zero increase. But while the BEA statistics suppress the increase in amount of chained dollars, they disclose the increase in percent, and that was a stunning 133.4%.

From old files, we know that hedonic pricing had turned the computer investment of $109.3 billion in 2000 into $290.3 billion in chained dollars. The reported further increase by 133.4% since then puts the corresponding amount in chained dollars for the first quarter of 2006 at $677.6 billion annualized.

We have forever vehemently opposed the use of hedonic pricing. It makes no economic sense. The crucial first-round impact of investment spending for economic growth resides in its immediate demand and income effects. But the hedonic pricing of computers creates a lot of GDP that completely lacks both effects. It is a statistical chimera.

In short, capital investment in the United States is much weaker than it seems. It is at its weakest ever. Already in the late 1990s, the trumpeted and celebrated investment boom arose entirely from hedonic pricing. The ugly reality was an unprecedented consumption boom unleashed by the stock market bubble.

CONCLUSIONS:

When the equity bubble popped in 2000–01, Mr. Greenspan was lucky to have the possibility to offset its negative impact on people's wealth by inflating the nascent housing bubble. But "asset-driven" economic growth is running out without a return to "income-driven" growth in sight.

The other outstanding Greenspan legacy is that unprecedented levels of private household debts have been leveraged against unprecedented levels of paper wealth (lacking any income) that can disappear tomorrow.

It is "inflationary pressures" on the prices of goods and services that induce the central banks to hike their interest rates. But asset inflation is first in the range of fire. The only thing to own is short-term first-class bonds.

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